OAKTREE | Insights

NAV Finance 101:

The Next Generation of Private Credit

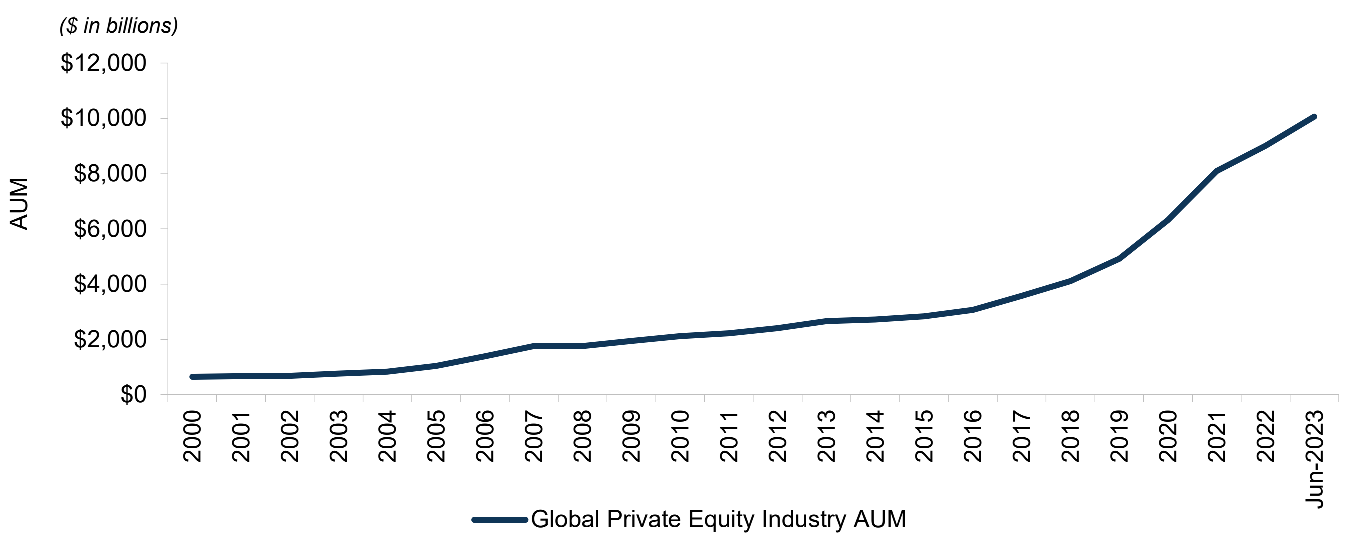
"Our job as fund managers is to make sure our investors' capital is well used: to create additional value, to support the companies that need it, to support the shareholders that are doing the right thing, to help companies remain the leaders in their fields. In short, to focus on what has the right purpose."

– Pierre-Antoine de Selancy, cofounder of 17Capital

What is NAV finance?

NAV finance refers to private capital solutions offered primarily to private equity funds based on the net asset value (NAV)[1] of their investment portfolios. It provides non-dilutive capital – mostly in the form of debt or senior equity – that can help borrowers enhance liquidity, create additional value, and more effectively manage their portfolios. While NAV finance has existed for over 15 years, its adoption has accelerated in recent years, alongside the dramatic growth of the private equity industry. Since 2019, assets under management (AUM) in the private equity market have almost doubled to roughly $10 trillion, which is more than triple the level in 2014.[2] (See Figure 1.)

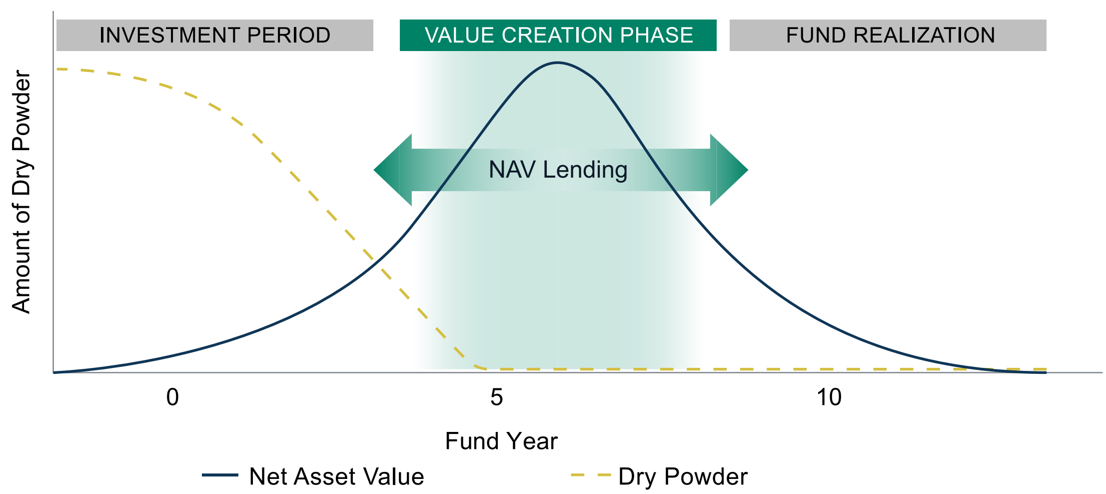
Figure 1: The Private Equity Industry Has Expanded Rapidly in Recent Years



Source: Preqin, as of June 30, 2023

Unlike revolving credit facilities, which are typically used during a private equity fund's investment period, NAV finance is usually provided either during a fund's value creation phase or very late in the investment period when most of the limited partners' capital has been called. (See Figure 2.)

Figure 2: NAV Lending Is Primarily Used During Private Equity Funds' Value Creation Phase



Source: 17Capital

NAV lending usually features bespoke loans that are structured based on the specific needs of the lender and borrower. However, there are several features that are common across most NAV loans:

- They are usually senior-ranking instruments that are collateralized by a diverse portfolio of private equity investments.
- They typically have long-dated maturities and floating-rate coupons.
- The payments to the NAV lender are funded via cash flows from the underlying investments.
- The loan-to-value ratios are typically low – only 5-30% compared to 35-60% for a typical middle-market direct lending deal.[3]
- Many of the assets in the underlying portfolio are expected to be monetized before the NAV loan matures.

What makes NAV finance attractive for lenders?

This rapidly growing area of private credit offers potential returns comparable to those seen in direct lending, but it typically also provides stronger downside protections. Moreover, returns in NAV finance have historically been correlated with the growth of the private equity industry, not the performance of individual assets, resulting in relatively low volatility.

Lenders also benefit from (a) the diversification of the underlying portfolios; (b) strong covenants; and (c) alignment of interest with sponsors, as NAV lenders will typically only face losses if a portfolio experiences a substantial decline in value. Additionally, while NAV loans are bespoke, they also tend to be fairly straightforward to execute, unlike many other forms of private credit, making them especially attractive for borrowers seeking speed in execution.

What are the benefits of NAV finance for borrowers?

NAV loans provide portfolio managers with liquidity while enabling them to maintain the equity upside of their underlying investments. Moreover, these loans give fund managers greater flexibility that can be used both offensively (e.g., to fund add-on acquisitions or to refinance more expensive debt) and defensively (e.g., to reduce the risk that a manager will have to sell assets at reduced prices during a dislocation or to support a struggling portfolio company).

Importantly, by enabling fund managers to generate liquidity and make add-on investments without sacrificing upside potential, NAV finance may be able to help increase long-term risk-adjusted returns for private equity funds and their investors.

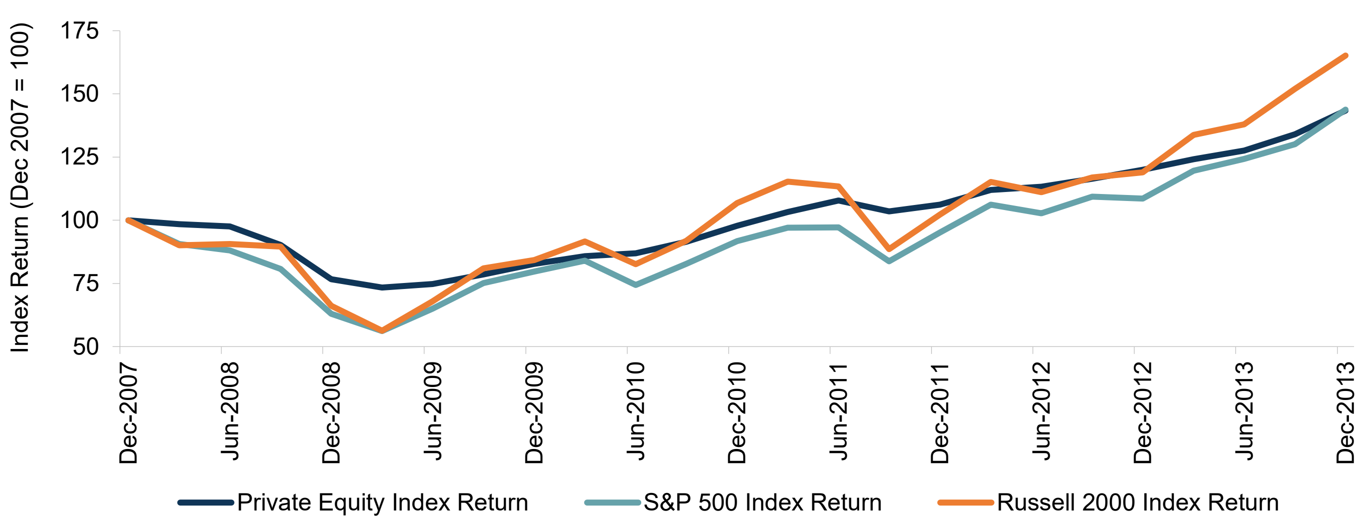
How is risk managed by NAV lenders?

NAV loans are senior instruments, meaning the lenders will be paid back before distributions are made to equity shareholders. However, it's important to note that even though a NAV loan is senior at the fund level, it's structurally subordinated to the investment-level creditors. In other words, the underlying portfolio companies will pay back their own lenders before cash moves up to the fund level, where it can be accessed by the NAV lender.

But as we stated above, NAV loans are collateralized by diverse investment portfolios and are typically made at LTV ratios below 30%, so the lender will only experience a loss if the value of the entire portfolio declines meaningfully. Such broad-based portfolio weakness is typically rare. In a study of 680 private equity portfolios created since 1990, less than 5% reported an investment multiple[4] below 0.5x, meaning that losses representing more than 50% of a portfolio's cost basis were quite rare.[5]

This reflects the fact that private equity funds have typically been quite resilient in recent decades, even during significant market dislocations. For example, during the Global Financial Crisis, the average value of private equity portfolios declined by around 25% from the level in December 2007, compared to decreases of roughly 45% in the broad public markets. (See Figure 3.)

Figure 3: Private Equity Portfolios Had Limited Volatility During the Global Financial Crisis and its Aftermath



Source: Prequin, Bloomberg[6]

Ultimately, we believe superior risk control in NAV lending begins with proper underwriting of the managers and the portfolio assets. Scrutinizing the quality and diversity of the underlying portfolio is crucial, as an increase in the equity value of one company can offset losses in another. Structuring expertise is also vital, as NAV lenders typically seek to reduce risk by including strict covenants that can provide substantial downside protection. For example, covenants frequently found in NAV loans can:

- limit the borrower's ability to take on additional debt;
- specify the minimum number of assets in the portfolio or include other requirements to enhance diversification;
- set a maximum LTV ratio that if exceeded, would require the borrower to fully repay the loan; and
- prohibit distributions to investors if an event of default occurs, until the lender is made whole.

> "When we make a loan to a fund or to an investor, we look at who's going to be running that fund. The first criteria is always, who is the manager? How long have they been operating? What is the track record? What are the resources? Where are they in the fundraising cycle? Are they raising a fund now? How is it going? What do they plan to raise in the next few years?"
>
> **– Pierre-Antoine de Selancy, cofounder of 17Capital**

What is the growth outlook for NAV finance?

NAV finance has experienced tremendous growth in recent years, as market conditions have shifted rapidly. NAV finance deal flow has more than doubled since 2020, rising to approximately $44 billion in 2023.[7]

This acceleration in activity began during the second quarter of 2020 – the heart of the Covid-19 pandemic. When many traditional financing channels became unavailable, private equity funds increasingly turned to NAV finance to ensure that they and their portfolio companies could continue operating. The growth in NAV lending was then turbocharged in the second half of 2020 and 2021, as private equity deal flow hit record-high levels.

Interestingly, appetite for NAV financing continued to rise even after private equity activity stalled following the spike in interest rates that began in early 2022. NAV finance became an especially attractive funding tool because the hawkish turn in U.S., UK, and European monetary policy and the attendant market dislocation (a) made it more challenging for sponsors to exit investments, (b) caused distributions to fall to record-low levels,[8] and (c) reduced liquidity broadly across financial markets. Consequently, most private equity funds turned their attention to add-on investments and liquidity management. In fact, roughly two-thirds of private equity investments in 2022 and 2023 were add-ons, as managers sought to find ways to continue creating value in a challenging financing environment.[9]

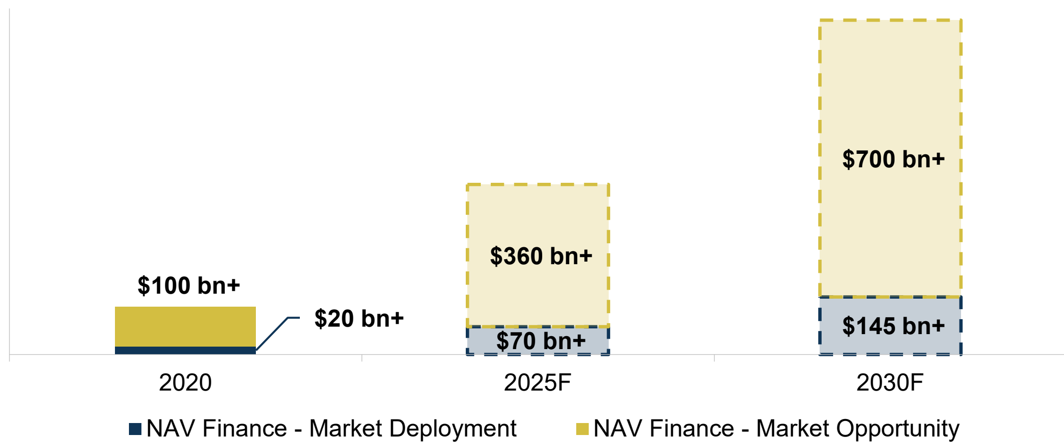
As we look forward, it's clear that growth in NAV finance will likely continue to be correlated with the expansion and evolution of the global private equity universe, which has seen its total AUM increase by roughly 15% annually on average over the last ten years.[10] Importantly, the AUM of private equity funds that are beyond their investment period – the target market for NAV finance – is expected to rise to more than $5.5 trillion in 2030, a roughly 60% increase since 2020.[11]

It's also notable that deal flow for NAV finance represented only 2% of private equity AUM in 2023, meaning it still has tremendous room to grow. This is especially true given that it's becoming increasingly popular with investment management companies and institutional investors as well.[12] Current estimates indicate that the NAV finance market could reach $145 billion by 2030.[13] (See Figure 4.)

Moreover, even though NAV finance first gained popularity in Europe, it has recently become more widely used in North America. In fact, NAV finance activity in North America increased by more than 30% in 2023, while it rose by around 20% year-over-year in Europe.[14] We anticipate that this form of financing will see its geographical reach expand further in the coming years.

We obviously can't predict exactly how financial markets will evolve in the years ahead, but we think the potential sea change in interest rates that Oaktree has written about extensively could encourage private equity sponsors to seek out new sources of finance, new ways to create value, and new means of enhancing flexibility. We're confident that NAV finance will play a major role in this ongoing evolution while providing investors with another way to increase their exposure to the expanding universe of private credit.

Figure 4: Use of NAV Finance Is Expected to Increase Dramatically



Source: Underlying data from Preqin overlayed with 17Capital's assumptions

Why did Oaktree partner with 17Capital?

In 2022, Oaktree acquired a majority interest in London-based 17Capital, a leader in the burgeoning field of NAV finance. Through this mutually beneficial arrangement, 17Capital gained access to Oaktree's expansive global network, Oaktree was able to enhance its already-extensive suite of private capital solutions, and both firms solidified their standing as partners of choice for the private equity sponsor community. The two firms have complementary business models, corresponding expertise, and – perhaps most importantly – strong philosophical alignment, as both strongly emphasize the importance of risk control and maintaining the highest ethical standards.

> "17Capital is the market leader in the NAV finance sector, one of the fastest-developing segments within the private credit asset class. 17Capital's emphasis on risk control is completely aligned with Oaktree's investment philosophy. We expect our complementary business models and corresponding expertise to fuel future growth at both firms."
>
> **– Armen Panossian, Oaktree Co-CEO and Head of Performing Credit**

For more information about NAV finance, please listen to the interview with 17Capital cofounder Pierre-Antoine de Selancy on Oaktree's new podcast, *The Insight by Oaktree Capital*.

Armen Panossian

Co-Chief Executive Officer and Head of Performing Credit

Mr. Panossian serves as co-Chief Executive Officer, primarily focused on overseeing the organization and performance of Oaktree's investment teams. He is also Head of Performing Credit, where his responsibilities include oversight of the firm's liquid and private credit strategies and as a portfolio manager within the Global Private Debt and Global Credit strategies. Mr. Panossian joined Oaktree's Global Opportunities group in 2007. In January 2014, he joined the U.S. Senior Loans team to assume co-portfolio management responsibilities and lead the development of Oaktree's CLO business. He became head of all performing credit in 2019. Mr. Panossian joined Oaktree from Pequot Capital Management, where he worked on their distressed debt strategy. Mr. Panossian holds a B.A. degree in economics with honors and distinction from Stanford University, where he was elected to Phi Beta Kappa; an M.S. degree in health services research from Stanford Medical School; a J.D. degree from Harvard Law School; and an M.B.A. from Harvard Business School. Mr. Panossian serves on the Advisory Board of the Stanford Institute for Economic Policy Research. He is a member of the State Bar of California.

Pierre-Antoine de Selancy

Cofounder and Managing Partner

Pierre-Antoine is Cofounder and Managing Partner of 17Capital, the go-to global source of strategic finance for investors in private equity having founded the business in 2008. Since then, 17Capital has raised over $11 billion, including the recent closing of its inaugural €2.6 billion NAV lending fund, and has deployed $13 billion across over 100 investments. In July 2022, 17Capital announced the completion of Oaktree's acquisition of a majority interest in 17Capital. The partnership will give 17Capital access to Oaktree's deep global network. Pierre-Antoine has nearly 30 years of private equity experience and is a member of the investment committee, working globally on NAV financing transactions and leads the fund raising efforts. Prior to 17Capital, Pierre-Antoine was a Partner in Idinvest's fund of funds (previously AGF Private Equity, part of Allianz), where he launched and led the secondary practice. Previously, he spent three years as an Investment Director at Fondinvest and at Coller Capital and PAI Partners. Pierre-Antoine has been recognised by Private Equity News as one of the 50 most influential people in European private equity for three years in a row. He studied at EM Lyon and ESLSCA business school.

Endnotes

1. NAV equals the total assets of an investment fund less its liabilities.
2. Preqin; AUM data refers to the global private equity universe, as of June 2023.
3. 17Capital observations in the market, as of January 2024; UBS. IPM Monthly Blog. September 2023.
4. This refers to the total value to paid-in capital (TVPI) multiple, which compares an investment fund's total value (the sum of all distributions made to LPs plus the unrealized value of the fund's remaining investments) to the amount of capital contributed to the fund. The multiple is a common measure of performance in the private equity industry.
5. Preqin as of October 2020. Data criteria: Private equity funds excluding venture strategy, North America/European focus, fund size greater than $100mm, fund vintage after 1990, liquidated funds with available final performance metrics. Total number of observations is 680.
6. Private Capital Quarterly Index per Preqin for the corresponding reference period. Data refers only to private equity strategies.
7. 17Capital, deal flow data as of December 2023.
8. Rede Partners Liquidity Index 2H2022.
9. EY Private Equity Pulse Q42022. January 2023.
10. Preqin, as of February 2024. Global private equity universe data from December 2014 to June 2023.
11. Preqin, as of September 2020.
12. 17Capital, deal flow data as of December 2023, with approximated aggregate underlying portfolio collateral value. AUM data refers to the global private equity universe, as of June 2023.
13. Data from Preqin overlayed with 17Capital assumptions, as of September 2020.
14. 17Capital analysis, data as of December 2023.

Notes and Disclaimers